

EXHIBIT F

FINANCIAL QUALIFICATIONS **OF KMC III, INC.**

KMC III has access to the financing and capital necessary to conduct its telecommunications operations as specified in the Petition. During an initial transition period, KMC III may rely in part upon the sizeable financial assets of its parent company, KMC Telecom Holdings, Inc., ("KMC Holdings"). In support of this Petition, KMC III submits the following financial information of KMC Holdings to demonstrate that it has sufficient access to capital and financial stability adequate to ensure its continued provision of quality local exchange and interexchange telecommunications services within the State of Illinois. KMC Holdings' most recent 10-K is appended hereto. As KMC III's revenues increase through the acquisition of customers, KMC III's revenues will supplant KMC Holdings' financial assistance.

KMC TELECOM HOLDINGS INC

Filing Type: 10-K
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO
SECTIONS 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

(MARK ONE)

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2000

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number: 333-50475

KMC TELECOM HOLDINGS, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE
(STATE OR OTHER JURISDICTION
OF INCORPORATION OR ORGANIZATION)

22-3545325
(I.R.S. EMPLOYER
IDENTIFICATION NO.)

1545 ROUTE 206
BEDMINSTER, NEW JERSEY 07921
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE)

Registrant's telephone number, including area code: (908) 470-2100

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT:
None

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT:
None

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. ☒ Yes ☐ No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K ☒.

The aggregate market value of the voting common stock held by non-affiliates of the registrant as of March 30, 2001 was approximately \$86,193,000 based upon an estimate of the fair value thereof by management of the registrant. There is no established trading market for the voting common

stock of the registrant and no sales have occurred within the past sixty days.

As of March 30, 2001, 861,145 shares of the registrant's Common Stock, \$0.01 par value, were outstanding. There is no established trading market for the Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE. None.

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CAUTIONARY STATEMENT REGARDING FORWARD - LOOKING STATEMENTS

STATEMENTS IN THIS ANNUAL REPORT ON FORM 10-K THAT ARE NOT PURELY HISTORICAL ARE FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933 AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, INCLUDING STATEMENTS REGARDING THE COMPANY'S EXPECTATIONS, HOPES, INTENTIONS OR STRATEGIES REGARDING THE FUTURE. FORWARD-LOOKING STATEMENTS INCLUDE: STATEMENTS REGARDING THE ANTICIPATED DEVELOPMENT AND EXPANSION OF OUR BUSINESS, THE MARKETS IN WHICH OUR SERVICES ARE CURRENTLY OFFERED, OR WILL BE OFFERED IN THE FUTURE, THE SERVICES WHICH WE EXPECT TO OFFER IN THE FUTURE, THE CONTINUING IMPLEMENTATION OF OUR OPERATIONS SUPPORT SYSTEM, OUR ANTICIPATED CAPITAL EXPENDITURES, OUR FUNDING NEEDS AND POTENTIAL FINANCING SOURCES, REGULATORY REFORM, THE INTENT, BELIEF OR CURRENT EXPECTATIONS OF THE COMPANY, OUR DIRECTORS OR OFFICERS WITH RESPECT TO OUR FUTURE FINANCIAL PERFORMANCE AND OTHER MATTERS, AND OTHER STATEMENTS REGARDING MATTERS THAT ARE NOT HISTORICAL FACTS. ALL FORWARD-LOOKING STATEMENTS IN THIS REPORT ARE BASED ON INFORMATION AVAILABLE TO THE COMPANY AS OF THE DATE THIS REPORT IS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION, AND THE COMPANY ASSUMES NO OBLIGATION TO UPDATE ANY SUCH FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS INCLUDE, BUT ARE NOT LIMITED TO, THE FACTORS SET FORTH IN "ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS -- CERTAIN FACTORS WHICH MAY AFFECT OUR FUTURE RESULTS."

PART I

ITEM 1. BUSINESS.

BACKGROUND

The initial predecessors of KMC Telecom Holdings, Inc. were founded in 1994 and 1995, respectively, by Harold N. Kamine, the Company's Chairman of the Board. These predecessors were merged in 1996 and renamed KMC Telecom Inc. KMC Telecom Holdings, Inc. was formed during 1997 primarily to own, directly or indirectly, all of the shares of its operating subsidiaries. The principal equity investors in the Company currently include Nassau Capital Partners L.P., Mr. Kamine, Lucent Technologies, Inc., General Electric Capital Corporation, CIT Lending Services Corporation, First Union Corp., and Dresdner Kleinwort Wasserstein.

COMPANY OVERVIEW

We are a rapidly growing fiber-based integrated communications provider offering data, voice and Internet infrastructure services. We offer these services to businesses, governments and institutional end-users, Internet service providers, long distance carriers and wireless service providers. Our business has two distinct components: serving communications-intensive customers in Tier III markets, and providing data services on a nationwide basis.

We provide a full suite of broadband communications services in 37 Tier III markets, which we define as markets with a population between 100,000 and 750,000. We own and operate robust fiber-based networks and Class 5 switching equipment in all of our Tier III markets, which are predominantly located in the South, Southeast, Midwest and Mid-Atlantic United States. We will continue to expand in our existing Tier III markets because we believe that these markets have attractive growth attributes and are typically less competitive than larger markets. Our customers in these markets include: AT&T, Boeing, City of Augusta, Columbia Hospital, NASA, Pillsbury, State of Wisconsin, Texas A&M University and Wal-Mart.

We also provide nationwide data services under long-term guaranteed revenue contracts. Under these contracts, we currently provide local Internet access infrastructure and other enhanced data services and will be providing Voice over Internet Protocol service, or VOIP, beginning in the second half of 2001. Currently, we have contracts representing approximately \$280 million in annualized revenues in approximately 140 markets. We expect these markets to be operational by the second quarter of 2001. The Internet infrastructure we are deploying includes the latest technology platforms from Cisco and Nortel, which we believe will result in a cost-effective and technologically superior solution for our customers.

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See Note 8 of the Notes to Consolidated Financial Statements contained in Item 8 of this Report on Form 10-K for financial information by Tier III Markets Segment and Nationwide Data Platform Segment.

BUSINESS STRATEGY

We intend to become a leading competitive provider of data and voice services in the Tier III markets that we serve directly. These services will be provided on an individual product basis and as part of value-added service bundles. We also intend to continue to form alliances with carriers in Tier I and II markets to deliver next generation data services. To accomplish these objectives we will:

CONTINUE TO OPERATE ROBUST FIBER OPTIC NETWORKS IN TIER III MARKETS TO SUPPORT BROADBAND APPLICATIONS. We will continue to expand our geographically extensive, full service, fiber-based networks in Tier III markets to support both voice and broadband data applications. We believe our networks are generally more technologically advanced than those of the incumbent local exchange carrier, facilitate the capture of market share, and are likely to deter other alternative competitive local exchange carriers from penetrating our markets due to the cost of constructing a competing network of equal capability. In all of our operational markets, we have completed our backbone construction connecting the market's central business district with outlying office parks, large institutions, the locations of long distance carriers' transmission equipment and major incumbent local exchange carrier central offices. Consistent with capital availability, we intend to continue to expand our networks in response to customer demand.

CONTINUE TO STRENGTHEN OUR LOCAL PRESENCE WITH PERSONALIZED CUSTOMER SERVICE IN TIER III MARKETS. We seek to capture and retain customers in Tier III markets through local, personalized sales, marketing and customer service programs. In order to accomplish this, we will continue to:

- o establish local sales offices in each market in which we operate a network,
- o recruit our city directors and sales staff primarily from the local market,
- o rely primarily on a face-to-face direct selling approach, and
- o support our sales staff with locally based customer service, billing and technical support personnel and participation in the local community.

Most of our existing sales personnel are local residents who have previously worked for the incumbent local exchange carrier or other telecommunications companies. We believe that our "Creative Solutions with a Hometown Touch(R)" sales approach is very important to customers in Tier III markets, who do not typically receive localized sales contact or customer support from the incumbent local exchange carrier.

EXPAND OUR DATA PLATFORM OFFERINGS BY LEVERAGING OUR RELATIONSHIPS WITH MAJOR CARRIER CUSTOMERS AND BY EXPANDING INTO NEW MARKETS. In Tier I, II and III markets, we are creating a nationwide next generation local broadband network to

provide data communications services through strategic alliances with major carrier customers. We believe that these alliances leverage our core strengths in managing technology and developing infrastructure and use the carriers' larger sales organizations to brand and distribute these capabilities. We expect to use our guaranteed revenue contracts with these carriers to reduce the risks associated with expansion. We will build our networks to meet existing requirements under these contracts while preserving the flexibility to rapidly and cost-effectively expand capacity with demand.

ENHANCE OUR EXISTING INFRASTRUCTURE TO DELIVER NEXT GENERATION VOICE AND DATA SERVICES. We will expand our existing infrastructure so that we can continue to offer new voice and data services, thereby enhancing our market penetration and maintaining low customer turnover. Services we expect to offer in the future include voice and data service bundles, xDSL-based applications, web hosting, data storage and backup, and application service hosting. We also intend to become the leading gateway for data communications services to the Tier III markets we serve. We provide data services directly to our own customers and to long distance carriers, Internet service providers and other businesses which require broadband access in our markets but do not currently have their own facilities or connections in those markets.

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SERVICES

We offer a comprehensive suite of data and voice services. Historically, we have resold switched services which we purchased from incumbent local exchange carriers. In December 1997, we began providing our own on-network services to our customers. Our on-network services and resale services account for all of our revenues. The allocation between on-network revenues and resale revenues was as follows:

	Year Ended December 31,		
	1998	1999	2000
On-network revenues.....	37%	69%	95%
Resale revenues.....	63%	31%	5%

VOICE SERVICES

For the year ended December 31, 2000, voice services accounted for approximately 25% of our revenue. These voice services include:

LOCAL SWITCHED SERVICES. Local switched services allow customers to connect their key systems and PBX system with the public network through dial tone lines and trunks. Dial tone lines also enable customers without premise-based communications systems to connect to the public network through stand-alone telephone devices. We also offer enhanced services such as call waiting, conferencing, speed dialing and voice mail to our customers. We currently have switches commercially operable in each of our 37 Tier III markets. We have added and will continue to add capacity in all markets to insure services are available when required by our customers.

LONG DISTANCE SERVICES. We offer a full range of long distance services including inter- and intra-LATA, interstate, international, calling card, prepaid calling card and 800 type services. We offer long distance services to our customers by entering into wholesale agreements with various long distance carriers and reselling their transmission services to our customers. We believe that many of our customers will prefer the option of purchasing long distance services from us in conjunction with their local switched services as part of their one-stop telecommunications solution.

CENTREX-TYPE SERVICES. Centrex-type services provide customers the functionality of PBX without the capital expense of installing these systems. Centrex-type services reduce customers' maintenance expenses and increase communications reliability. We introduced these services in all our operational

markets during 1999 and the first quarter of 2000. These services feature call forwarding, speed dialing, conferencing and intercom, transfer and voice mail capabilities. Centrex-type services can be provided over standard voice connections or, where voice and data services are required, ISDN connections.

DATA SERVICES

Data services represented approximately 75% of our revenue for the year ended December 31, 2000. We believe that these services enhance our ability to provide an integrated turnkey solution to our customers' data, voice and video transmission requirements. Our current data service offerings include:

PRIMARY RATE ISDN. Primary Rate ISDN provides customers the equivalent of 1.544 megabits per second of digital communications via a T-1 type facility, with 23 channels for data and voice communications and a 24th channel providing network signaling and control for the services. We focus our Primary Rate ISDN sales efforts on Internet service providers who use it as a means of supporting customer access to their operations, and end-user customers who use it as a network access facility for their internal telecommunications systems.

INTERNET INFRASTRUCTURE. Our Internet infrastructure service provides large bandwidth users with data switching capability at the network level, allowing them to acquire capacity as required without investing in data switching equipment. Internet infrastructure service gives us the ability to provide data switching to Internet service providers by allowing data calls to

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be terminated through port wholesale equipment rather than the switch. This enables the Internet service provider to more cost effectively manage its data requirements while, at the same time, increasing the efficiency and capacity of our Class 5 switches.

BASIC RATE ISDN. Basic Rate ISDN, or BRI, provides customers the potential of 144 kilobits per second of digital communications via a single network facility interface. We believe this service is attractive to medium and small size customers, since it provides dial-up access to the Internet, and other dial-up data applications, while simultaneously providing the ability to integrate voice traffic on a single network facility.

PRIVATE LINE AND SPECIAL ACCESS SERVICES. We currently provide various types of on-network dedicated services which permit the transmission of voice and data between two or more specified points and are dedicated to a particular customer. Private line services are provided over dedicated lines and are available in different capacities. DS-1 lines are dedicated lines that provide 24 separate channels that transport voice and/or data. DS-3 lines provide 672 channels. The use of the channels and capacity of the service is determined by the needs of the customer. Special access services are provided to long distance carriers to connect their customers to the long distance carriers' locations or to multiple locations of the carrier. The services are provided over DS-1 and DS-3 lines. If additional capacity is desired we have the ability to provide OC-3, OC-12 and higher capacities that deliver multiple DS-3 equivalent capacities. Our private line and special access services are designed to meet the needs of our customers.

FRAME RELAY/ATM. Frame relay and ATM, or asynchronous transfer mode, are used by some of our data customers as a fast data transport service for Wide Area Networks. Today we resell these services. In the future we intend to provide these services over our own network and utilize a third party provider for transport outside our network.

Our future data service offerings will include:

INTERNET ACCESS SERVICES. We plan to offer Internet access services in partnership with several carriers beginning in the second half of 2001.

APPLICATION SERVICE PROVIDER. Through the second quarter of 2001 we will conduct a proof of concept trial in two Tier III cities of a range of KMC hosted and managed application services. These services include managed Internet

access with a selection of security options (i.e. firewall, URL filtering, virus scanning and intrusion detection) as well as a variety of hosted software applications provided on a subscription basis. These applications range from common desktop productivity tools like Microsoft Office and Microsoft Exchange electronic mail/calendaring and contact management, to semi-custom accounting applications from Quicken and Great Plains as well as select industry specific vertical solutions. Depending on the results of the trial and the interest of our customer base, this service may be rolled out to all of our Tier III markets in the future.

WEB HOSTING. We plan to offer web site design services and web hosting on secured, monitored servers. These services will provide small to medium size customers a turn key e-commerce solution.

DATA STORAGE AND BACKUP. We plan to offer automatic and secure off-site storage of enterprise data. These services will include consulting, testing and hosting, with 24 hours-per-day, seven days-per-week monitoring.

DSL. DSL, or digital subscriber line, is a method of using existing copper wire for high bit-rate data transport in the "last mile" connecting our network backbone ring to the customer's premises. DSL provides the customer with a choice of bandwidth based upon its particular needs. Beginning in 2001, we plan to offer HDSL, SDSL and ADSL in selected markets to provide high bandwidth data and video service to medium and small size business customers. We have deployed DSLAMs, or digital subscriber line access multiplexers, in collocation offices in 29 of our Tier III cities. These DSLAMs are equipped and configured to support two access products; first to provide an optimized T-1 service via HDSL, and second to provide ADSL and SDSL applications directly to our customers.

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OPERATIONS SUPPORT SYSTEM

We continue the implementation of our high quality operations support system encompassing comprehensive billing, service order, customer care and electronic bonding capability. The system is expected to support our existing and contemplated services. The installation of the operational support systems has been substantially completed with development and expansion to continue as needed. The system is designed to provide us with a single "flow-through" order system that will allow each order to be tracked from service provisioning through installation.

We implemented the service order module and the number tracking module in all our existing Tier III markets in July and August 2000. The implementation included full testing of capabilities and training of personnel in all Tier III markets. All existing Tier III markets are utilizing the system for order entry.

We are currently electronically bonded with five carriers and expect to be electronically bonded with our remaining carriers during 2001. Electronic bonding is the ability to electronically share customer order information between us and the incumbent local exchange carrier or interconnection carrier. Even when we are electronically bonded, we may not achieve the anticipated efficiencies if the information provided to us by the incumbent local exchange carrier is not in a format that we can readily use or if the incumbent local exchange carrier does not promptly provision new lines for us.

The asset and inventory modules, which will provide each market's inventory, are currently being loaded with the necessary data including line data. Completion of the data loading, verification process and testing will conclude the implementation and provide full "flow-through" capability during 2001.

We believe that our operations support system will allow us to quickly address customer concerns, and improve operations efficiency which provides us with a significant competitive advantage.

TIER III MARKETS

We target Tier III markets, which we define as markets with a population from 100,000 to 750,000. As part of our market selection process we analyze the demographic, economic, competitive and telecommunications demand characteristics of the market. We estimate market demand using data gathered from long distance carriers, the Federal Communications Commission, local sources, site visits and specific market studies commissioned by us. Through the utilization of 20 databases, we also analyze the concentration of potential business, government and institutional end-user customers and the general economic prospects for the area.

We depend upon a detailed business analysis coupled with a "success-based" return on capital employed analysis to drive our capital deployment. Each year capital is deployed based on forecasts, and investment is made when the forecasted investment return exceeds our threshold requirement.

Once we target a Tier III market for development, we design a network to provide access to approximately 80% of the business customers in that market either through direct connections to our network or through unbundled network elements leased from the incumbent local exchange carrier. Typically, we construct a SONET, or self-healing synchronous optical network, backbone ring to provide coverage of the major business districts, government offices, hospitals, office parks and universities, the principal locations of the transmission equipment of long distance carriers offering services in the area, and the incumbent local exchange carrier's central office(s). Following construction of our backbone network, we build additional loops to increase the size of our addressable market as demand grows.

The construction of a network requires us to obtain municipal franchises and other permits. These rights are typically subject to non-exclusive agreements of finite duration providing for the payment of fees by us or the provision of services by us to the municipality without compensation. In addition, we must secure rights-of-way and other access rights which are also typically provided under non-exclusive, multi-year agreements and generally contain renewal options. Generally, these rights are obtained from utilities, incumbent local exchange carriers, other competitive local exchange carriers, railroads and long distance carriers. The Telecommunications Act of 1996

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requires most utilities to provide rights-of-way to competitive local exchange carriers on non-discriminatory terms and conditions and at reasonable rates.

Our requirements for a planned network are communicated to KNT Network Technologies LLC which provides program management for construction of the outside plant portion of the network. Our own personnel negotiate required contracts and rights-of-way and test the network components prior to commencing commercial service. Cable, equipment and supplies required for the networks are available from a variety of sources at competitive rates. The construction period for a new network varies depending upon such factors as the number of backbone route miles to be installed, the relative use of aerial as opposed to buried cable deployment, the initial number of buildings targeted for connection to the network backbone and other factors. We believe that a new fiber optic network can be commercially operable within approximately nine months after construction commences.

During Phase I of our network construction program we completed networks in eight Tier III markets. We completed networks in 15 Tier III markets during Phase II of the program and added networks in 14 additional markets during Phase III. All of the 14 networks in Phase III were operational as of December 31, 2000. The markets in which we established networks during each phase of the program are as follows:

PHASE I

PHASE II

PHASE III

Huntsville, Alabama	Daytona Beach, Florida	Montgomery, Alabama
Melbourne, Florida	Fort Myers, Florida	Clearwater/St. Petersburg,
Florida		
Augusta, Georgia	Pensacola, Florida	Monroe, Louisiana
Savannah, Georgia	Sarasota, Florida	
Rockville/Bethesda/Frederick,		
Baton Rouge, Louisiana	Tallahassee, Florida	Maryland
Shreveport, Louisiana	Fort Wayne, Indiana	Lansing, Michigan
Corpus Christi, Texas	Topeka, Kansas	Biloxi/Gulfport,
Mississippi		
Madison, Wisconsin	Ann Arbor, Michigan	Akron, Ohio
	Eden Prairie, Minnesota	Dayton, Ohio
	Fayetteville, North Carolina	Toledo, Ohio
	Greensboro, North Carolina	Charleston, South Carolina
	Winston-Salem, North Carolina	Columbia, South Carolina
	Longview, Texas	Spartanburg, South
Carolina		
	Norfolk, Virginia	Chattanooga, Tennessee
Tennessee	Roanoke, Virginia	Johnson City/Kingsport,

The following table provides aggregate data as of February 28, 2001 for the networks placed in operation during Phase I, Phase II and Phase III of our network construction program, respectively:

	TOTAL LINES IN SERVICE (1)	ROUTE MILES	ADDRESSABLE COMMERCIAL BUILDINGS(2)	COLLOCATIONS
Phase I (8 markets).....	574,109	751	14,853	33
Phase II (15 markets).....	1,126,992	915	26,214	55
Phase III (14 markets).....	331,661	657	27,294	46
Total.....	2,032,762	2,323	68,361	134

-
- (1) Represents all active switched channels we provide to customers either by unbundled network elements leased from the incumbent local exchange carrier, by direct connection to our own network, or by resale via the incumbent local exchange carrier's network and all active dedicated lines we provide to customers expressed on a DS-0 equivalent basis.
- (2) Addressable by either unbundled network elements leased from the incumbent local exchange carrier or by a direct connection to our own network. We define a commercial building as one with greater than ten employees.

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TIER III NETWORK ARCHITECTURE

Our networks are designed for high-speed data and voice communications, using Class 5 digital switching devices. These devices are deployed in all of our networks, as part of a total central office configuration that includes electronic digital cross connect devices, SONET transport equipment and associated DC power plants and AC emergency power facilities. We currently offer end-to-end fully protected fiber services using the SONET ring architecture which routes customer traffic simultaneously in both directions around the ring to provide protection against fiber cuts. If a line is cut, traffic is automatically reversed and sent to its destination around the other side of the ring. In addition, back-up electronics become operational in the event of failure of the primary components. The switches and associated transport

equipment are deployed in an initial configuration that permits rapid growth as our business in the local market grows. Our networks provide access to customers through SONET-based fiber optic rings for on-network service and through unbundled network elements which are connected to our central office through SONET fiber rings between the incumbent local exchange carrier tandem and at least two incumbent local exchange carrier service offices. In addition, at least three interexchange carriers are connected from their points of presence to our central office by SONET rings, for long distance connectivity.

We expedite new market service installation by deploying our switch-in-the-box concept using a turn key process that allows installation and testing of the switch in specially designed portable buildings at the manufacturing facility before deployment. The switch and its housing are then shipped and placed on-site for integration into the network.

We have deployed subscriber loop carrier equipment in each incumbent local exchange carrier collocation for connection to customer premise equipment, and service is then concentrated for transport to our central office for distribution. In addition, we are deploying equipment to permit digital subscriber line (DSL) services to be served on qualifying unbundled network element copper facilities. The incumbent local exchange carrier collocations are engineered to provide access to business, institutional, governmental or other large customers. In addition, for large customer services, the fiber backbone can be extended to provide fiber access all the way to the business complex or building for on-network services. We provide customer premise electronic equipment to connect to both unbundled network element and on-network facilities.

We have also deployed a nationwide primary rate interface (PRI) capability that permits the provisioning of Internet infrastructure services to large Internet service providers without the need to utilize the Class 5 switching capacity. This capability is managed via two centralized KMC NextGen SoftSwitch controllers, which permit the growth of Internet services quickly. This technology provides economical and highly scalable PRI growth and avoids the higher cost associated with placing additional capacity on the existing Class 5 switch in each city.

We currently deploy a 72 pair-strand fiber optic network. Our optical bandwidth capacity in fiber rings ranges from OC-3 to OC-48. We are actively conducting both field and lab trials of dense wave division multiplexing (DWDM) to enhance bandwidth capability in our Tier III markets.

We monitor our fiber optic networks and electronics 24 hours-per-day, seven days-per-week, using a combination of local and national network control centers. Local network monitoring is accomplished by means of an automatic notification system that monitors for system anomalies. This system provides instantaneous alarms to an on-call network technician whenever an anomaly is detected. The local market technician is trained in network problem resolution and provides on-site corrective procedures when appropriate. A national Network Knowledge Center, located in Denver, Colorado, acts as the focal point for all of our operating networks, providing integrated and centralized network monitoring, correlation and problem management. The Network Knowledge Center has access to all operating networks and can work independently of the local systems to effect repair or restoration activities. The Network Knowledge Center is currently provided by Lucent on a contractual basis.

The Network Knowledge Center receives, tracks and manages all customer calls and issues to satisfactory conclusion. The call center works with our own customer care representatives and engineers in the Lawrenceville facility to ensure that timely and consistent service is provided. In order to enhance customer service, we will be bringing these call center services exclusively in-house during 2001.

NATIONWIDE DATA PLATFORM

We are a growing nationwide provider of Internet infrastructure in Tier

I, II and III markets. We currently provide dial-up Internet access and other data services to carriers using remote access servers, a type of switch that uses Internet Protocol rather than traditional circuit-based switching. This technology uses packets to transfer information and uses bandwidth more efficiently and at a lower cost than similar services based on circuit switching. We are deploying a nationwide data platform which we believe will enable us to reach approximately 50% of the U.S. population. In March 2001, we signed an agreement with Qwest to provide Voice over Internet Protocol, or VOIP, services on over 30% of this Nationwide Data Platform, beginning in the second half of 2001.

We are deploying a platform that will provide Internet access infrastructure, remote access service capability, and VOIP services in Tier I, II and III markets across the United States. In the markets in which we currently provide integrated communications services, connectivity is integrated into our existing architecture. In the markets in which we do not operate systems, we establish a point of presence, lease fiber and provide the Internet service providers with the same basic architecture for their applications. This provides the capability to create revenue for these major customers beyond our existing markets.

Going forward, the application of Internet Protocol packet technology to the public-switched telephone network may provide many distinct advantages over the current time division multiplexing transport infrastructure, including:

- o much less expensive and demanding deployment, less costly equipment, lower space and power requirements, and faster implementation,
- o the ability for customers to integrate data and voice over the same networks, saving cost and complexity, as well as the ability to support new services combining both data and voice communications,
- o the opportunity for carriers to leverage the growing volume of data traffic, and
- o DSL, fiber, and other broadband access technologies are particularly compatible with packet-based transport.

As national and global carriers implement managed Internet Protocol networks for end-to-end connectivity, they will require local Internet Protocol infrastructure, including local access devices, packet switches and routers, SS7 and other gateways, and local softswitches.

We currently have a local infrastructure for dial-up access pursuant to agreements with several next generation carriers and Internet service providers. In the second half of 2001, we will begin implementing Voice over Internet Protocol. Additional opportunities include broadband Internet Protocol platforms. This initiative is consistent with our current strategy and infrastructure and, we believe, will also position us as a major participant among next-generation telecom providers.

Voice over Internet Protocol is not currently being used by the telecommunications industry to any material extent for many of the purposes we believe it will serve in the future.

Our existing contracts require us to provide over one million ports in approximately 140 markets nationwide by the second quarter of 2001. We are currently in the process of deploying Cisco and Nortel equipment to provide these ports through 41 supernodes, or concentration points for high-speed connectivity to the Internet, located in various cities, including ten in our existing markets. Our service allows our carrier customers to provide their own customers with dial-up access to the Internet. Under the current regulatory scheme, those calls may qualify for reciprocal compensation which would be incremental to the guaranteed revenues that we receive from our carrier customers.

All of these contracts to date have been structured so that our customers pay a fixed amount to us, regardless of their level of usage. These contracts have terms of 42 to 51 months and have certain cost pass-throughs

which allow us to limit our maintenance and servicing costs to predetermined levels, and receive additional revenues for any costs incurred in excess of such predetermined levels.

We currently have a dedicated team devoted to service and maintenance under these contracts. We expect personnel demands to diminish significantly after initial deployment, which will reduce our costs associated with this business, over the remaining lives of these contracts.

NEW TECHNOLOGY EVALUATION

We evaluate and test new concepts and capabilities in our laboratory in Lawrenceville, Georgia, as well as in field trials. New capabilities for existing technologies are evaluated, along with emerging technologies that could potentially be used for voice, data or converged voice/data services. We are currently evaluating next generation metropolitan DWDM, PRI and modem pooling technology, SoftSwitch, Passive Optical Networks, High Speed Optical Ethernet MANs, and various next generation Internet Protocol based multi-service platforms.

SALES

We target our sales activities at three separate customer groups: Tier III local customers, Tier III national customers and national data platform customers. Tier III local customers include local governments, hospitals and educational facilities as well as businesses. Tier III national customers are usually interexchange carriers or large corporations which have branches or local offices within our Tier III markets, but which make their buying decisions centrally from their corporate offices. National data platform customers include major long distance carriers and Internet service providers.

TIER III LOCAL. We establish local sales offices in each Tier III market we serve. Each local sales office is staffed by a city director, six to eight account executives and sales support personnel. The sales support personnel include customer service, technical, and billing personnel. During 2001 we will be establishing an alternate channel sales program to complement the efforts of our local sales offices. We anticipate that the program will include partner marketing, direct marketing, and various eCommerce business-to-business based initiatives, as well as referral programs. Partner marketing will consist of our performing joint marketing efforts with sales agents selected from companies that are currently selling to or servicing customers with whom we also want to do business. The sales agents could be systems integrators, telecommunications equipment suppliers, Internet service providers, information technology consultants, and telecommunications consultants. These agents would sell our products and their products at the same time as part of a total solution. The direct marketing program will be used to generate demand through direct mailings and telemarketing campaigns. e-Commerce business-to-business based initiatives may include e-marketing to our embedded customer base, targeted e-lists, or implementation of a KMC web-based order process. Referral programs would involve enlisting the aid of business contacts our account executives have established who would be willing to pass on sales leads in exchange for a commission.

We seek to hire local, seasoned telecommunications managers with sales experience as City Directors. City Directors assist with the initial network build out and oversee the daily operations of their networks, in addition to managing sales staff and market development. Their daily operations responsibilities include management of provisioning, customer service, pricing decisions and the billing process. City Directors work with senior management in the strategic planning process, including capital expenditure and budget planning. They perform cash flow analysis for fiber connections of new buildings to the network, and participate in planning fiber network extensions in their markets.

In our Tier III markets, we use a face-to-face direct sales force of

approximately 180 account executives. Most of our sales personnel are hired locally because we believe that knowledge of, and contacts in, a local market are key factors for competitive differentiation and commercial success in a Tier III market. We believe that this local focus will help to set us apart from the incumbent local exchange carriers, our principal competitors in these markets.

TIER III NATIONAL. While there are few Fortune 500 companies with headquarters located in our operating cities, there are branches and local offices of large corporations within our market areas. Often these large corporations make their buying decisions centrally, either through their telecommunications or MIS functions, which are normally located at corporate

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headquarters. Our national markets sales organization is structured to assist them in determining requirements for their various locations within our markets. Additionally, this group targets regional and national interexchange carriers, primarily for the sale of transport services. We believe that this focus on national markets will further increase our market penetration with carriers and large companies in our cities. We currently have 17 national market account managers.

NATIONWIDE DATA SERVICES. We have nationwide data services customer account managers who build relationships with major long distance carriers and Internet service providers. These relationships facilitate initial sales of our services. We believe, and our contracts with our existing customers have shown, that once national data platform customers experience our service they will allow us to provide additional services to them and expand the relationship.

We recruit our sales force from several sources including incumbent local exchange carriers, competitive local exchange carriers, interexchange carriers, cellular companies and interconnect companies. Once hired, our local Tier III sales force is put through a program of intense local training and computer based data and voice product training at the local sales office. All sales personnel participate in consultative sales and product training at our corporate operations facility. Our sales force is compensated based on a fixed base salary and variable payments for the sale of recurring monthly revenue.

CUSTOMERS

Contracts with Qwest Communications Corporation and Qwest Communications International, Inc. (collectively, "Qwest") accounted for approximately 36% of our total revenue for the year ended December 31, 2000. A significant portion of the Qwest business was generated from long term guaranteed revenue contracts. No other customer accounted for 10% or more of our revenues for the year ended December 31, 2000. For the year ended December 31, 1999, no one customer accounted for more than 10% of revenue. It is unlikely that the loss of any single customer, other than Qwest, would have a material adverse effect on our business, financial condition or results of operations.

As of February 28, 2001, we had approximately 12,700 customers, which can be broken down into the following categories:

- o Tier III local customers are local to a particular city and include local governments, hospitals and educational facilities as well as businesses, including local and regional Internet service providers. Our business customers range from large businesses to medium and small size businesses, including medical and insurance offices, car dealerships, broadcast media outlets and real estate brokerages.
- o Tier III national customers consist of Fortune 500 companies, regional and national interexchange carriers, other large companies, major long distance carriers, wireless service providers and other competitive local exchange providers that have a local or branch office in several of our markets.
- o Nationwide data platform customers consist of major long distance carriers and Internet service providers.

Examples of our customers in each of these categories are shown below:

TIER III LOCAL CUSTOMERS PLATFORM SERVICES CUSTOMERS ----- -----	TIER III NATIONAL CUSTOMERS -----	DATA -----
Boeing	AT&T Corp.	
Broadwing		
City of Augusta, Georgia	Burlington Northern Santa Fe Railway	Qwest
Columbia Hospital	Krispy Kreme Donuts	
NASA	Sprint	
Pillsbury	UUNET	
State of Wisconsin	Walgreens	
Texas A&M University	Walmart	

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MARKETING

We market our local services through a combination of media channels and personal service in each of our local markets. We seek to gain brand awareness through advertising on local television, radio and print media. We also use outdoor advertising in prominent locations, customer testimonials, and local events and sponsorships, such as charity golf tournaments.

Consistent with our "Creative Solutions with a Hometown Touch(R)" motto, we also seek to actively participate in our local communities. Each City Director is typically a long-time local resident with extensive telecommunications experience and is well known and respected in the community. The City Director typically seeks to hire other local residents, further strengthening our involvement with and contacts throughout the local market. Each local office is typically an active member of the local Chamber of Commerce, and contributes to local charities. We believe that these activities provide us with a point of differentiation compared to the incumbent local exchange carriers, who have generally underserved Tier III markets in favor of larger markets.

SUPPLIERS

We depend on a number of suppliers in order to operate our networks. The following companies are our primary suppliers.

TELECOMMUNICATIONS EQUIPMENT. We have contracted with Lucent, as our primary supplier, to purchase switching, transport and digital cross connect products. Lucent has also agreed to implement and test our switches and related equipment. In addition, we have entered into an agreement with Lucent pursuant to which Lucent has agreed to monitor our switches on an on-going basis. Lucent is an investor in our preferred stock and a lender under our credit facilities.

BILLING SUPPORT SYSTEMS IMPLEMENTATION. In the second quarter of 1999, we installed software developed by Billing Concepts Systems, Inc./APTIS to provide us with comprehensive billing functionality, including the ability to capture call detail records, message rating, bill calculation, invoice generation, customer care and inquiry, collections management, and quality assurance. This software enables us to produce a single bill covering all of the products and services that we provide to a customer. Additional development of new billing functionality continues.

OPERATIONAL SUPPORT SYSTEMS IMPLEMENTATION. We entered into an agreement in 1998 with Eftia OSS Solutions Inc. to develop our operational

support systems. These systems manage service order processing, circuit and asset inventory, telephone number inventory and trouble administration. The installation of the operational support systems has been substantially completed with development and expansion to continue as needed.

OUTSIDE NETWORK RELATED CONSTRUCTION. We are currently in negotiations to complete the transfer of our construction division to KNT Network Technologies, LLC, a company independently owned by Harold N. Kamine and Nassau Capital, our principal stockholders. Pursuant to an arrangement between the parties, effective June 1, 2000, we transferred substantially all of the employees of our construction division to KNT. KNT is providing construction and maintenance services to us and is being reimbursed for all of the direct costs of these activities. In addition, we are currently funding substantially all of KNT's general overhead and administrative costs at an amount not to exceed \$15 million per annum. We are currently negotiating with KNT to finalize the terms of this arrangement and execute a formal contract which is required to be completed by June 15, 2001.

The services and products which we obtained from these principal suppliers are also available from a number of other sources. If we were forced to change suppliers for any reason, however, we may experience some difficulties, particularly with respect to the compatibility of equipment from new suppliers with our existing Lucent equipment.

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COMPETITION

OVERVIEW. The telecommunications industry is highly competitive. Our principal competitors in Tier III markets are the incumbent local exchange carriers. In most instances the incumbent local exchange carrier is one of the regional Bell operating companies (such as Verizon, BellSouth or SBC). Incumbent local exchange carriers presently have a majority of the market share in those areas we consider our market areas. Because of their relatively small size, we do not believe that Tier III markets can profitably support more than two facilities-based competitors in addition to the incumbent local exchange carrier.

Other competitors may include competitive local exchange carriers, microwave carriers, wireless telecommunications providers and private networks built by large end-users. Potential competitors (using similar or different technologies) include cable television companies, utilities, incumbent local exchange carriers, regional Bell operating companies seeking to operate outside their current local service areas and independent telephone companies. In addition, there will be future competition from large long distance carriers, such as AT&T and MCI WorldCom, which have begun to offer integrated local and long distance telecommunications services. Consolidation of telecommunications companies and the formation of strategic alliances within the telecommunications industry, as well as the development of new technologies, could give rise to significant new competitors for us.

Both the long distance business and the data transmission business are extremely competitive. Prices in both businesses have declined significantly in recent years and are expected to continue to decline. In the long distance business, we will face competition from large carriers such as AT&T, MCI WorldCom and Sprint. We will rely on other carriers to provide transmission and termination for our long distance traffic and therefore will be dependent on such carriers.

A large portion of our nationwide data platform business will be conducted in larger Tier I and Tier II markets. We expect that our primary competitors in this business will be both incumbent local exchange carriers and other competitive local exchange carriers. Because the regional Bell operating companies and other incumbent local exchange carriers tend to focus their efforts on Tier I and Tier II markets, they will have a significantly greater local presence in these markets. In addition, due to the larger size of the markets, there are a greater number of facilities-based competitive local exchange carriers competing for data business in these markets than we usually

face in Tier III markets. For this reason, we generally will not enter these markets to offer nationwide data platform services unless we have a pre-existing agreement with a significant customer justifying our presence in the market.

INCUMBENT LOCAL EXCHANGE CARRIERS. Our principal competitors for local exchange services are the regional Bell operating companies. As a recent entrant in the integrated telecommunications services industry, we have not yet achieved a significant market share for any of our services. In particular, the incumbent local exchange carriers:

- o have long-standing relationships with their customers,
- o have financial, technical and marketing resources substantially greater than ours,
- o have the potential to fund competitive services with revenues from a variety of other businesses, and
- o currently benefit from a number of existing regulations that favor the incumbent local exchange carriers over us in some respects.

COMPETITIVE LOCAL EXCHANGE CARRIERS AND OTHER COMPETITORS. We compete from time to time with competitive local exchange carriers. In our markets we generally face competition from two or more competitive local exchange carriers. However, in many instances, the competitive local exchange carriers present in our Tier III markets have not established robust fiber-based networks comparable to ours. After the investment and expense of establishing a network and support services in a given market, the marginal cost of carrying an additional call is negligible. Accordingly, in Tier III markets where there are three or more fiber-based competitive local exchange carriers, we expect substantial price

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competition. We believe that operations in such markets are likely to be unprofitable for one or more operators.

We face competition in each of our markets. However, we believe that our commitment to build a significant network, deploy switches and establish local sales and support facilities at the outset in each of the Tier III markets which we target should reduce the number of facilities-based competitors and drive other entrants to focus on the resale of incumbent local exchange carrier service or our services or to invest in other markets. We believe that each market will also see more agent and distributor resale initiatives.

REGULATION

Our services are subject to varying degrees of federal, state and local regulation. The Federal Communications Commission exercises jurisdiction over facilities of, and interstate and international services offered by, telecommunications common carriers. The state regulatory commissions retain jurisdiction over the same facilities and services to the extent they are used to originate or terminate intrastate communications. Local governments sometimes impose franchise or licensing requirements on competitive local exchange carriers. The regulatory environment is in a constant state of flux, and you should be aware that any of the items discussed below are subject to rapid change due to regulatory action, judicial decision or legislative initiative.

FEDERAL REGULATION

We are regulated at the federal level as a nondominant common carrier subject to minimal regulation under Title II of the Communications Act of 1934. The Communications Act of 1934 was substantially amended by the Telecommunications Act of 1996. This legislation is designed to enhance competition in the local telecommunications marketplace by:

- o removing state and local entry barriers,
- o requiring incumbent local exchange carriers to provide

interconnection to their facilities,

- o facilitating the end-users' choice to switch service providers from incumbent local exchange carriers to competitive local exchange carriers like us, and
- o requiring access to rights-of-way.

The legislation also is designed to enhance the competitive position of competitive local exchange carriers and increase local competition by newer competitors such as long distance carriers, cable television companies and public utility companies. Under the Telecommunications Act of 1996, regional Bell operating companies have the opportunity to provide in-region long distance services if specified conditions are met. In addition, the Telecommunications Act of 1996 eliminates certain restrictions on utility holding companies, thus clearing the way for them to diversify into telecommunications services.

The Telecommunications Act of 1996 specifically requires all telecommunications carriers (including incumbent local exchange carriers and competitive local exchange carriers (like us)):

- o not to prohibit or unduly restrict resale of their services,
- o to provide dialing parity and nondiscriminatory access to telephone numbers, operator services, directory assistance and directory listings,
- o to afford access to poles, ducts, conduits and rights-of-way, and
- o to establish reciprocal compensation arrangements for the transport and termination of telecommunications.

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It also requires competitive local exchange carriers and incumbent local exchange carriers to provide interconnection for the transmission and routing of telephone exchange service and exchange access. It requires incumbent local exchange carriers to provide such interconnection:

- o at any technically feasible point within the incumbent local exchange carrier's network,
- o that is at least equal in quality to that provided by the incumbent local exchange carrier to itself, its affiliates or any other party to which the incumbent local exchange carrier provides interconnection, and
- o at rates, terms and conditions that are just, reasonable and nondiscriminatory.

Incumbent local exchange carriers also are required under the law to provide nondiscriminatory access to network elements on an unbundled basis at any technically feasible point, to offer their local retail telephone services for resale at wholesale rates, and to facilitate collocation of equipment necessary for competitors to interconnect with them or obtain access to their unbundled network elements.

The Telecommunications Act of 1996 provided for the removal of most restrictions imposed on AT&T and the regional Bell operating companies resulting from the consent decree entered in 1982 which provided for divestiture of the regional Bell operating companies from AT&T in 1984. The Telecommunications Act establishes procedures under which a regional Bell operating company can enter the market for long distance service between specified areas within its in-region local service territory. The Telecommunications Act of 1996 permitted the regional Bell operating companies to enter the out-of-region long distance market immediately upon enactment. Before the regional Bell operating company can provide in-region inter-LATA services, it must obtain Federal Communications Commission approval upon a showing that facilities-based competition is present in its market, that the regional Bell operating company has entered into

interconnection agreements in the states where it seeks authority, that it has satisfied a 14-point "checklist" of competitive requirements, and that its entry is in the public interest. To date, such authority has only been granted to Verizon (formerly Bell Atlantic) for New York and SBC for Kansas, Oklahoma and Texas. A petition by Verizon for entry in Massachusetts is pending at the Federal Communications Commission. The provision of inter-LATA services by regional Bell operating companies is expected to reduce the market share of major long distance carriers, and consequently, may have an adverse effect on the ability of competitive local exchange carriers to generate access revenues from long distance carriers.

FEDERAL COMMUNICATIONS COMMISSION RULES IMPLEMENTING THE LOCAL COMPETITION PROVISIONS OF THE TELECOMMUNICATIONS ACT OF 1996. The Federal Communications Commission in 1996 established a framework of national rules enabling state public service commissions and the Federal Communications Commission to begin implementing many of the local competition provisions of the Telecommunications Act of 1996. The Federal Communications Commission prescribed certain minimum points of interconnection necessary to permit competing carriers to choose the most efficient points at which to interconnect with the incumbent local exchange carriers' networks. The Federal Communications Commission also adopted a minimum list of unbundled network elements that incumbent local exchange carriers must make available to competitors upon request and a methodology for states to use in establishing rates for interconnection and the purchase of unbundled network elements.

In January 1999, the Supreme Court ruled on a variety of issues addressed in the Federal Communications Commission's 1996 order. Among other things, the Supreme Court found that the Federal Communications Commission has authority to establish national pricing rules for interconnection, unbundled elements and resale services. However, the Supreme Court overturned the Federal Communications Commission's rules regarding what network elements must be unbundled by the regional Bell operating companies, and remanded to the Federal Communications Commission the question of what network elements are "necessary" to competing carriers like us. On November 5, 1999, the Federal Communications Commission issued an order re-establishing the network elements that must be offered by incumbent local exchange carriers as unbundled network elements. That decision is currently the subject of various reconsideration petitions and appeals. We cannot provide any assurances regarding the disposition of these petitions and appeals and we cannot assure you that we will be able to maintain interconnection agreements on terms acceptable to us.

On July 18, 2000, the U.S. Court of Appeals for the 8th Circuit issued a decision in which it upheld the Federal Communications Commission's use of a forward-looking methodology to establish prices for network elements, but the

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Court vacated the agency's rule that the methodology should be applied based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration. Rather, the Court held that the methodology must be applied based on the costs of the incumbent local exchange carriers' existing facilities and equipment. The issue was remanded to the Federal Communications Commission for further consideration. The Court's ruling is currently under review by the U.S. Supreme Court. A decision by the Supreme Court is expected in the Court's fall 2001 term. We are unable to provide assurances as to the outcome of the Supreme Court case or of the remand proceeding that must be conducted by the Federal Communications Commission.

The 8th Circuit also affirmed its prior decision to vacate the Federal Communications Commission rule that required incumbent local exchange carriers to provide combinations of network elements that are not ordinarily combined in their networks. The Court's decision keeps in place the system whereby carriers cannot obtain network element combinations unless the incumbent local exchange carrier has already combined the elements in its network today. The Supreme Court is currently reviewing this issue as well as the pricing issue described above.

On March 17, 2000, the U.S. Court of Appeals for the District of Columbia Circuit vacated certain Federal Communications Commission rules

relating to collocation of competitors' equipment in incumbent local exchange carriers' central offices. This decision requires the Federal Communications Commission to limit collocation to equipment that is "necessary" for interconnection with the incumbent local exchange carrier or access to the incumbent local exchange carrier's unbundled network elements. On August 10, 2000, the Federal Communications Commission responded by issuing an order and request for further comment. The agency required that incumbent local exchange carriers provide physical collocation within 90 days after receiving an application and clarified that an incumbent local exchange carrier must allow a competitive local exchange carrier to construct a controlled environmental vault or similar structure on land adjacent to an incumbent local exchange carrier structure that lacks physical collocation space. The Federal Communications Commission asked for comment on what equipment incumbent local exchange carriers should allow competitive local exchange carriers to physically collocate and how physical collocation space should be assigned, whether collocators should be permitted to cross-connect with other collocators, and what rules should apply to collocation at remote local exchange carrier premises. No assurances can be given regarding the outcome of this further proceeding.

OTHER REGULATION. In general, the Federal Communications Commission's policies encourage the entry of new competitors in the telecommunications industry and are designed to prevent anti-competitive practices. Currently, large incumbent local exchange carriers, such as the regional Bell operating companies, are regulated as "dominant" carriers, while competitive local exchange carriers, like us, are considered "nondominant" carriers. Dominant carriers face more detailed regulatory scrutiny. As a nondominant carrier, we are subject to relatively minimal Federal Communications Commission regulation.

- o TARIFF. We may install and operate facilities for the transmission of domestic interstate communications without prior Federal Communications Commission authorization. The Federal Communications Commission requires us to file periodic reports concerning our interstate circuits and deployment of network facilities, and offer interstate services on a nondiscriminatory basis, at just and reasonable rates. We also remain subject to Federal Communications Commission complaint procedures.

The Federal Communications Commission adopted an order in 1996 (the "Detariffing Order") which eliminated the requirement that nondominant interstate carriers maintain tariffs on file with the Federal Communications Commission for domestic interstate services. On April 28, 2000, the U.S. Court of Appeals for the D.C. Circuit upheld the Commission's decision. The Federal Communications Commission subsequently issued a notice establishing a 9-month transition to mandatory detariffing. This transition period was subsequently extended. However, by July 31, 2001, carriers must cancel all tariffs for interstate domestic interexchange services. After that date, the terms and conditions pursuant to which domestic providers offer service to customers will be governed by contract. On March 16, 2001 the Federal Communications Commission adopted a mandatory detariffing requirement for most international interexchange services provided by non-dominant carriers. The Commission provided a nine month transition period to permit carriers to adjust to this additional detariffing requirement. The Federal Communications Commission is currently considering whether to expand the mandatory detariffing requirement to the interstate access services provided by competitive local exchange carriers.

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- o ACCESS CHARGES. The Federal Communications Commission has granted incumbent local exchange carriers significant flexibility in pricing their interstate special and switched access services. We anticipate that this pricing flexibility will result in incumbent local exchange carriers lowering their prices in high traffic density areas, where our customers are concentrated.

In late May 2000, the Federal Communications Commission adopted an

order establishing a five-year plan for reforming federal access charges. The order provides for reductions in the usage-based and flat-rate charges assessed by incumbent local exchange carriers or long distance service providers. The order also provided for increases over time in the flat-rate monthly charges assessed directly by incumbent local exchange carriers on residential and business subscribers. The agency concluded that the plan as adopted would result in a more rational interstate rate structure, which in turn would result in more efficient competition.

- o UNIVERSAL SERVICE REFORM. The Federal Communications Commission implemented the provisions of the Telecommunications Act of 1996 relating to the preservation and advancement of universal telephone service in 1997. All telecommunications carriers providing interstate telecommunications services, including us, must contribute to the universal service support funds. On October 8, 1999, the Federal Communications Commission released an order implementing changes to its universal service rules to comply with a decision of the Fifth Circuit Court of Appeals. Among other changes, the Federal Communications Commission revised its rules concerning assessment of carriers' interstate and international revenues for universal service contribution. The Federal Communications Commission narrowed the scope of the contribution base, removing intrastate end-user telecommunications revenues from the assessment, consistent with the opinion of the Fifth Circuit Court of Appeals.

STATE REGULATION

We believe that most, if not all, states in which we operate or propose to operate require a certification or other authorization to offer intrastate and local services. These certifications generally require a showing that the carrier has adequate financial, managerial and technical resources to offer the proposed services in a manner consistent with the public interest. We have obtained state authority for the provision of our competitive local exchange and exchange access services and long distance services in those states where we currently operate and we plan to obtain additional state authorizations as our business expansion plans require. In most states, we are required to file tariffs setting forth the terms, conditions and prices for services that are classified as intrastate.

Some states also impose reporting, customer service and quality requirements, as well as unbundling and universal service requirements on competitive local exchange carriers. In addition, we are subject to the outcome of proceedings held by state commissions to determine state regulatory policies with respect to incumbent local exchange carrier and competitive local exchange carrier competition, geographic build-out, mandatory detariffing and other issues relevant to competitive local exchange carrier operations. Some states have adopted state-specific universal service funding obligations.

In addition to obtaining state certifications, we must negotiate terms of interconnection with the incumbent local exchange carriers before we can begin providing local exchange and exchange access services. Our executed agreements are subject to the approval of the state commissions. The appropriate commissions have approved each of our current agreements and we anticipate state commission approval of our future interconnection agreements.

We believe that, as the degree of local competition increases, the states will offer the incumbent local exchange carriers increasing pricing flexibility. This flexibility may present the incumbent local exchange carriers with an opportunity to subsidize services that compete with our services with revenues generated from non-competitive services, thereby allowing incumbent local exchange carriers to offer competitive services at prices below the cost of providing the service. We cannot predict the extent to which this may occur, but it could have a material adverse effect on our business.

We also may be subject to requirements in some states to obtain prior approval for, or notify the state commission of, any transfers of control, sales

of assets, corporate reorganizations, issuances of stock or debt instruments and related transactions.

LOCAL GOVERNMENT AUTHORIZATIONS. We are required to obtain street use and construction permits and licenses and/or franchises to install and expand our fiber optic networks using municipal rights-of-way. In some municipalities where we have installed or anticipate constructing networks, we will be required to pay license or franchise fees based on a percentage of gross revenues or on a per foot basis, as well as post performance bonds or letters of credit. We are actively pursuing permits, franchises and other relevant authorities for use of rights-of-way and utility facilities in a number of cities.

FRANCHISES AND PERMITS

The construction of a network requires us to obtain municipal franchises and other permits. These rights are typically the subject of non-exclusive agreements of finite duration providing for the payment of fees or the provision of services by us to the municipality without compensation. In addition, we must secure rights-of-way and other access rights which are typically provided under non-exclusive multi-year agreements, which generally contain renewal options. Generally, these rights are obtained from utilities, incumbent local exchange carriers, other competitive local exchange carriers, railroads and long distance carriers. The Telecommunications Act of 1996 requires most utilities to afford access to rights-of-way to competitive local exchange carriers on non-discriminatory terms and conditions and at reasonable rates. However, there can be no assurance that delays and disputes will not occur. Our agreements for rights-of-way and similar matters generally require us to indemnify the party providing such rights. Such indemnities could make us liable for actions (including negligence) of the other party.

EMPLOYEES

As of February 28, 2001, we had 1,266 full time employees. None of our employees are represented by a labor union or subject to a collective bargaining agreement, nor have we experienced any work stoppage due to labor disputes. We believe that our relations with our employees are good. The labor market in the telecommunications industry is currently very competitive and we compete for qualified personnel with many of our competitors. We believe that our compensation and benefits package is competitive in the telecommunications industry. See Item 7 of this Report on Form 10-K - "Management's Discussion and Analysis of Financial Condition and Results of Operations--Certain Factors Which May Affect Our Future Results -- The Future Success of Our Business Depends Upon Key Personnel."

GEOGRAPHIC AREAS

We have no foreign operations. All of our networks are located in, and all of our revenues are attributable to, the United States.

ITEM 2. PROPERTIES.

We are headquartered in Bedminster, New Jersey and recently expanded the space that we lease in our building from 20,000 to 50,000 square feet of office space. This recent expansion should be sufficient to meet any of our corporate headquarters space requirements for the near future. The lease requires us to pay an annual base lease rent of approximately \$1.0 million (adjusted periodically for changes in the consumer price index), plus operating expenses through 2012. We rent this space from a company in which a trust for the benefit of Mr. Kamine's children has an ownership interest. See Item 11 of this Report on Form 10-K - "Executive Compensation - Compensation Committee Interlocks and Insider Participation."

We also maintain an operations center and additional administrative offices in Lawrenceville, Georgia. The Lawrenceville premises is approximately 104,000 square feet held under a lease that expires in 2011. Our annual base rental obligation for these premises is \$1.3 million (adjusted periodically for changes in the consumer price index), plus operating expenses. We also own or lease facilities in each of our existing Tier III markets for central offices, sales offices and the location of our switches and related equipment. We lease collocation space for our Internet infrastructure equipment in our Nationwide Data Platform cities. We expect to lease an additional 50,000 square feet of

space in Lawrenceville, Georgia starting in the second half of 2001 at an annual cost of \$650,000. This additional facility should be sufficient to satisfy our near term space requirements.

We believe that our facilities are in good condition, are suitable for our operations and that, if needed, suitable alternative space would be readily available.

ITEM 3. LEGAL PROCEEDINGS.

We are from time to time involved in litigation incidental to the conduct of our business. There is no pending legal proceeding to which we are a party which, in the opinion of our management, is likely to have a material adverse effect on our business, financial condition and results of operations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matters were submitted to a vote of security holders during the fourth quarter of 2000.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

There is currently no established trading market for our Common Stock, \$0.01 par value per share. As of March 30, 2001, there were ten holders of record of our Common Stock.

We have never declared nor paid cash dividends on our Common Stock and do not presently anticipate paying any cash dividends on our Common Stock in the foreseeable future. We currently expect that earnings, if any, will be retained for growth and development of our business.

As a holding company, we depend upon the receipt of dividends and other cash payments from our operating subsidiaries in order to meet our cash requirements. Pursuant to the terms of our Amended and Restated Loan and Security Agreement, dated as of February 15, 2000, among certain of our principal operating subsidiaries and a group of lenders led by First Union National Bank, CIT Lending Services Corporation and Lucent (the "Amended Senior Secured Credit Facility"), those subsidiaries are restricted in their ability to pay dividends on their capital stock. The indentures applicable to our 13 1/2% Senior Notes due 2009 and our 12 1/2% Senior Discount Notes due 2008, respectively, impose certain restrictions upon our ability to pay dividends on our capital stock.

Subject to the foregoing and to any restrictions which may be contained in any future indebtedness which we may incur, the payment of cash dividends on our Common Stock will be within the sole discretion of our Board of Directors, and will depend upon the earnings, capital requirements and financial position of the Company, applicable requirements of law, general economic conditions and other factors considered relevant by our Board of Directors.

On January 1, 2000, March 6, 2000, April 1, 2000, May 1, 2000, June 6, 2000, July 1, 2000 and October 1, 2000, the Company granted options to purchase an aggregate of 255,674 shares of its Common Stock to employees and directors of the Company, as well as independent contractors who perform services for the Company, under the 1998 Stock Purchase and Option plan for Key Employees of KMC Telecom Holdings, Inc. and Affiliates. No consideration was received for the issuance of the options. The options have various exercise prices with 127,500 exercisable at an exercise price of \$75 per share, 2,500 exercisable at an exercise price of \$125 per share, 64,508 exercisable at an exercise price of \$250 per share, and 61,166 exercisable at an exercise price of \$300 per share. The issuance of these options was made in reliance upon the exemption from the registration requirements of the Securities Act provided by Section 4(2) of the Act, on the basis that the transactions did not involve a public offering.